Weekly Commentary

15 April 2019

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Close call

The outlook for monetary policy is delicately poised. Following the Reserve Bank's change of tone in its March OCR review, we shifted our call to a rate cut as early as the May *Monetary Policy Statement*, but we emphasised that this was subject to upcoming data. We expect this week's inflation report to be subdued, but we're sensitive to any surprises. Meanwhile, a trio of soft activity indicators will have added to the RBNZ's concerns about whether the local economy has the momentum needed to generate a lift in inflation.

The RBNZ Governor's comments in a media interview last week were in line with our initial read of the March OCR review. Governor Orr noted that the March statement was meant to reflect that the balance of risks has shifted to the downside. But he emphasised that the decision in May is by no means settled.

On balance, we still think that the odds are in favour of a rate cut in May. The RBNZ has highlighted concerns about the slowing global economy in particular – a point that was underscored last week when the IMF further downgraded its world growth forecasts. We're more optimistic on global growth than the market appears to be, but we don't think that gloomy sentiment will dissipate within the space of a few weeks.

In terms of local developments, the March quarter CPI release on Wednesday presents the most immediate risk to our view. We're expecting a subdued 0.2% increase for the quarter, which would take annual inflation down from 1.9% to 1.6%. The expected slowdown is entirely due to fuel prices. Petrol prices fell sharply at the end of 2018, and though they've started to tick up again in recent weeks, the average price over the quarter was down by more than 6%.

We expect that 'core' inflation (excluding food and fuel) will hold steady at 1.7%. Similarly, we estimate that the RBNZ's sectoral factor model of core inflation will remain at 1.7%. That would keep these measures comfortably within the RBNZ's target range of 1-3%, though still on the lower side of the midpoint.

Our CPI forecast is in line with what the RBNZ forecast in its February *Monetary Policy Statement*. If it turns out as expected, or lower, it's likely that inflation will remain below 2% for the remainder of this year. That in itself wouldn't warrant an OCR cut, but it wouldn't stand in the way of one either. However, if annual inflation prints at 1.8% or higher this week, a May OCR cut would become more difficult to envisage.

In the outlook for inflation, there is a tension between gradually increasing domestic price pressures and persistent softness in tradables prices (outside of the occasional surge in oil prices). The latter has been a global phenomenon, and probably reflects a combination of the modest cyclical upturn since the Global Financial Crisis, and new technology that has helped to liberate consumers compared to the past.

In contrast, non-tradables inflation has been gradually picking up – we expect it to rise to 2.9% in March, compared to 2.3% a year ago. We (and the RBNZ) have been anticipating such a move, as the economy has moved closer to full capacity. But given the ongoing softness in tradables prices, that's still somewhat short of what would be consistent with a sustained return to 2% overall inflation.

Close call

A further pickup in non-tradables inflation will depend on the strength of the economy. Growth slowed in the second half of 2018, and so far the March quarter of this year is shaping up as similarly subdued. We still expect a pick-up in growth over the rest of this year, supported by rising government spending, a strong pipeline of building work, and rising household incomes. But there are clearly risks to the downside.

On that note, there was a trio of activity indicators last week that were distinctly on the soft side. House sales fell further in March, and were down 13% on a year ago. Turnover was already dropping earlier this year, but back then the weakness was concentrated in Auckland. In March, it seems that there was a sharp drop in sales in almost every region. A decline in market turnover, along with a rising inventory of unsold properties in Auckland and Waikato, is a reliable signal of price weakness ahead.

Concerns about changes to the tax treatment of property, and reduced foreign buyer activity, are likely to be weighing on the housing market. In the near term, we expect the recent sharp falls in mortgage rates to give some support to house prices, but tax changes are likely to win out in the long run.

Electronic card spending in retail stores fell 0.3% in March, which was weaker than we had expected. Annual spending growth has also taken a step down over the past year, slowing to just 0.7%. This slowdown is consistent with the recent easing in consumer confidence, as well as the cooling in the housing market – spending on durables, which includes home furnishings, was particularly soft in March.

Finally, the manufacturing PMI fell to an eight-month low of 51.9 in March. The PMI is a useful leading indicator of GDP, and while it remains at a level consistent with expansion, it has clearly taken a step lower in the last year.

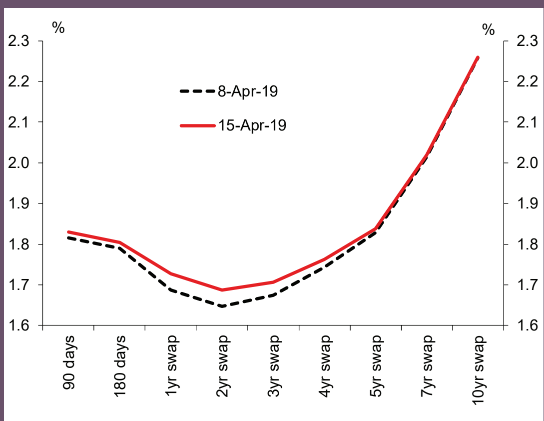
Fixed vs Floating for mortgages

Fixed mortgage rates have fallen recently, but they could fall even further in the near future. If the RBNZ cuts the OCR in May, fixed rates may drop again at that time.

We expect floating and one-year fixed mortgage rates to fall over the next year, but to gradually rise again in subsequent years. Based on that expectation, we regard three-year rates at the best on offer at present. One- and two-year rates are also fairly good value, with neither particularly preferred to the other.

Four- and five-year fixed rates have fallen sharply, but they still look high relative to where we expect shorter-term rates to go over those timeframes. Floating mortgage rates are expensive for borrowers, but they may be the preferred option for those who require flexibility in their repayments.

NZ interest rates



The week ahead

NZ Q1 CPI

Apr 17, Last: 0.1%, Westpac f/c: 0.2%, Mkt f/c: 0.3%

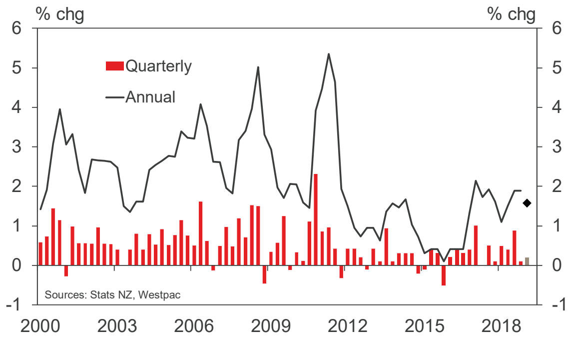
- We expect a 0.2% rise in the Consumer Price Index in the March quarter. That would see annual inflation slow from 1.9% to 1.6%. Such a result would be in line with the RBNZ's forecasts from February.
- The sharp drop in fuel prices at the end of last year is entirely responsible for the slowdown in inflation. We expect the various 'core' inflation measures to hold steady at close to, but just below, the 2% midpoint of the Reserve Bank's target range.
- The CPI release will be crucial ahead of the Reserve Bank's next Monetary Policy Statement. A result in line with or below expectations would support our forecast of an OCR cut in May. However, a substantial upside surprise would make a May OCR cut a more marginal prospect.

Aus Mar Westpac–MI Leading Index

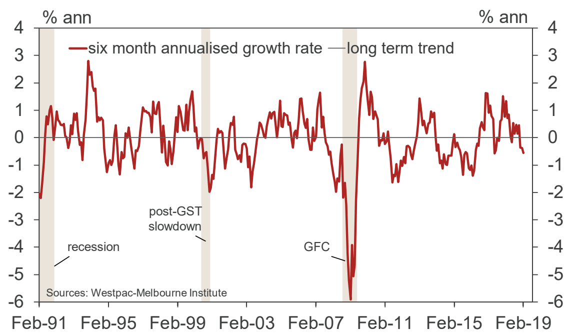
Apr 17, Last: –0.56%

- The six month annualised growth rate in the Westpac–Melbourne Institute Leading Index, which indicates the likely pace of economic activity relative to trend three to nine months into the future, fell from –0.37% in January to –0.56% in February. Despite choppy reads in recent months, the signal is consistent with weak momentum in the second half of 2018 carrying into 2019.
- The March read is likely to be more positive with several components recording strong rises this month including: the Westpac-MI Consumer Expectations Index, up 5.4% vs -6.1% last month and dwelling approvals, up 19.1% vs 2.3% last month. Other components have been more mixed but have mostly seen modest improvements.

NZ CPI inflation



Westpac-MI Leading Index



Aus Mar Labour Force Survey - employment '000

Apr 18, Last: 4.6k, WBC f/c: 8k
Mkt f/c: 15k, Range: 8k to 33k

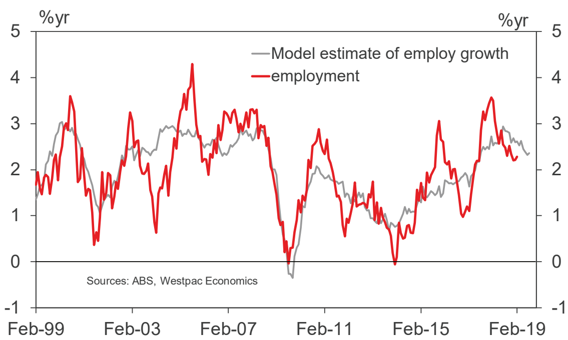
- Employment lifted 4.6k in Feb, less than market expectations (median +15k) for a three month average gain of 21.1k per month. Through 2018 employment grew 274.5k (2.2%yr). In the year to Feb employment grew 284k (2.3%yr).
- Leading indicators have softened, annual growth in Job Ads is now down (through the year but this reflects the structural shift to other recruitment methods). ABS Job Vacancies growth has slowed from 24%yr in 2018 to 10%yr in 2019 and our own Westpac Jobs Index suggest firms may be less confident on lifting employment. Our forecast 8k gain in employment holds the annual pace at 2.3%yr.

Aus Mar Labour Force Survey - unemployment %

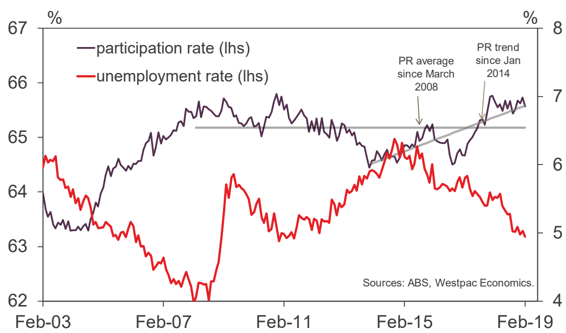
Apr 18, Last: 4.9%, WBC f/c: 5.1%
Mkt f/c: 5.0%, Range: 4.8% to 5.1%

- Despite the soft print on employment in Feb, the unemployment rate fell to 4.9% (market median was 5.0%) as a 0.1ppt decline in the participation rate to 65.6% resulted in a –7.1k decline in the labour force.
- At this stage it appears that both male and female participation is levelling out in a trend sense and we are closely watching where they go next. We do expect both to edge lower though 2019 as employment growth stalls but not by enough to prevent a rise in unemployment.
- Holding the participation rate flat at 65.6% generates a 31k rise in the labour force, and given our forecast for a soft 8k rise in employment, this should see the unemployment rate lift to 5.1%.

Lead indicators have peaked but remain sound



Unemployment and participation rates



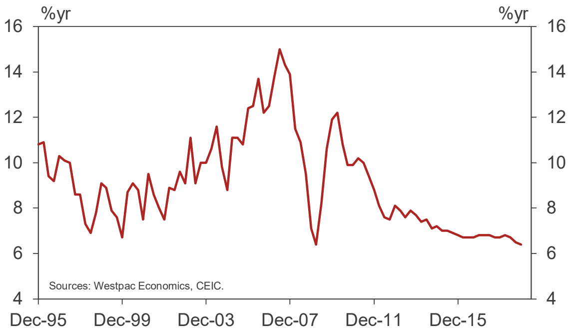
The week ahead

China Q1 GDP

Apr 17, last 6.4%, WBC 6.4%

- China GDP decelerated slowly through 2018, from 6.8%yr at March to 6.4%yr at December. This trend decline was the consequence of softening global momentum and authorities' hard line on the quality of investment, in both the public and private sector.
- With the economy's focus on quality now set, authorities have materially increased liquidity, with flow-on benefits for the cost of credit. A quick acceleration in growth is however not anticipated in 2019.
- The reason being that, while investment will accelerate through the year, the contribution from consumption is expected to throttle back. In 2018, employment growth slowed (based on the PMI detail), and this will weigh on consumption hence.
- For 2019 overall, we look for a 6.1% year-average gain.

China real GDP slowly decelerating

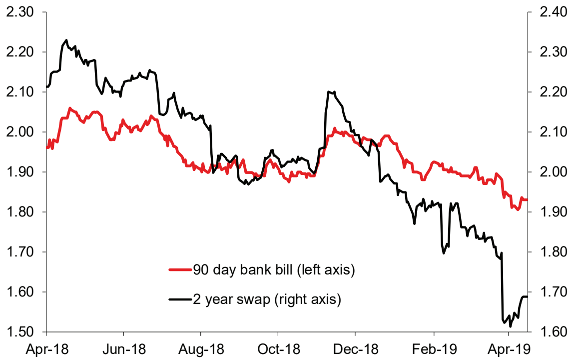


New Zealand forecasts

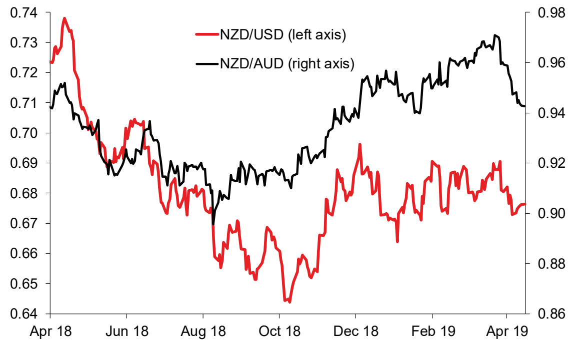
Economic Forecasts	Quarterly				Annual			
	2018	2019						
% change	Dec (a)	Mar	Jun	Sep	2018	2019f	2020f	2021f
GDP (Production)	0.6	0.5	0.8	0.8	2.8	2.5	2.8	2.0
Employment	0.1	0.2	0.3	0.4	2.3	1.2	1.6	1.3
Unemployment Rate % s.a.	4.3	4.4	4.4	4.2	4.3	4.2	4.0	4.0
CPI	0.1	0.2	0.5	0.7	1.9	1.7	2.1	2.1
Current Account Balance % of GDP	-3.7	-3.4	-3.2	-3.1	-3.7	-2.9	-2.8	-2.8

Financial Forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Cash	1.50	1.50	1.50	1.50	1.25	1.25
90 Day bill	1.60	1.60	1.60	1.50	1.40	1.40
2 Year Swap	1.50	1.50	1.60	1.60	1.50	1.50
5 Year Swap	1.70	1.75	1.85	1.85	1.85	1.85
10 Year Bond	1.80	1.85	1.90	1.85	1.85	1.90
NZD/USD	0.65	0.65	0.66	0.66	0.65	0.65
NZD/AUD	0.93	0.96	0.97	0.96	0.94	0.93
NZD/JPY	72.8	73.5	74.6	73.9	72.2	71.5
NZD/EUR	0.59	0.59	0.60	0.59	0.58	0.57
NZD/GBP	0.50	0.49	0.50	0.50	0.49	0.49
TWI	71.4	72.1	73.0	72.3	70.8	70.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 15 April 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.87%	1.86%	1.86%
60 Days	1.84%	1.86%	1.87%
90 Days	1.83%	1.85%	1.88%
2 Year Swap	1.69%	1.63%	1.84%
5 Year Swap	1.84%	1.77%	1.97%

NZ foreign currency mid-rates as at 15 April 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6764	0.6823	0.6844
NZD/EUR	0.5986	0.6073	0.6044
NZD/GBP	0.5170	0.5233	0.5147
NZD/JPY	75.73	75.70	76.30
NZD/AUD	0.9426	0.9584	0.9659
TWI	73.42	74.17	74.41

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Mar BusinessNZ PSI	53.8	–	–	Recent surveys have highlighted softening activity.
UK	Apr Rightmove house prices	0.4%	–	–	There's been no let-up in the uncertainty weighing on prices.
US	Apr Fed Empire state index	3.7	8.0	–	Regional surveys broadly positive but volatile.
	Feb total net TIC flows	–143.7	–	–	US Treasuries in strong demand.
	Fedspeak	–	–	–	Evans on the economy and policy in NY.
Tue 16					
Aus	RBA minutes	–	–	–	A more distinct sign of shifting to an easing bias?
Eur	Apr ZEW survey of expectations	–2.5	–	–	Has stabilised in recent months.
UK	Feb ILO unemployment rate	3.9%	4.0%	–	Growth stabilised in early 2019, unemployment to remain low.
US	Mar industrial production	0.0%	0.3%	–	More sedate than the PMI's.
	Apr NAHB housing market index	62	64	–	Has recovered some ground as rates have fallen.
	Fedspeak	–	–	–	Rosengren in NC, Kaplan in NM.
Wed 17					
NZ	Q1 CPI	0.1%	0.3%	0.2%	Dragged down by fuel prices, core stable a little below 2%.
	GlobalDairyTrade auction	0.8%	–	–	Pace of improvement in dairy prices has been slowing.
Aus	Mar Westpac–MI Leading Index	–0.56%	–	–	Fell in Feb but key components lifted in March
Chn	Mar fixed asset investment ytd %yr	6.1%	6.3%	–	Will slowly build momentum through the year.
	Mar industrial production ytd %yr	5.3%	5.6%	–	Modest growth continuing.
	Mar retail sales ytd %yr	8.2%	8.3%	–	Consumer under pressure owing to weaker job growth.
	Q1 GDP %yr	6.4%	6.3%	6.4%	GDP growth to decelerate further in 2019.
Eur	Feb trade balance €bn	17.0	–	–	Surplus declined over 2018
	Mar core CPI %yr final	0.8%	0.8%	–	Flash undershot expectations.
UK	Mar CPI	0.5%	0.2%	–	Core just below 2%, not showing signs of picking up.
US	Feb trade balance US$bn	–51.1	–53.6	–	Tariffs have caused considerable volatility.
	Feb wholesale inventories	1.2%	0.4%	–	Trade volatility seen in inventories too.
	Federal Reserve's Beige book	–	–	–	Conditions across the districts.
	Fedspeak	–	–	–	Bullard at Minsky conf., Harker in NJ, and NY Fed's Logan.
Thu 18					
Aus	Mar employment	4.6k	15.0k	8.0k	Our 8k forecast holds the 2.3%yr annual pace, on par with...
	Mar unemployment rate	4.9%	5.0%	5.1%	...the leading indicators but result in a lift in unemployment.
	Q1 NAB business survey	7	–	–	In March month, conditions at +7, confidence slumped to 0.
Eur	Apr Markit manufacturing PMI flash	47.5	–	–	Quite weak in Mar...
	Apr Markit services PMI flash	53.3	–	–	... but services lifted...
US	Mar retail sales	–0.2%	0.8%	–	US consumer growth to moderate, but remain solid in '19.
	Initial jobless claims	196k	–	–	Very low.
	Apr Phily Fed index	13.7	11.0	–	Regional surveys broadly positive but volatile.
	Apr Markit manufacturing PMI flash	52.4	53.0	–	Continuing to point to robust growth...
	Apr Markit services PMI flash	55.3	55.0	–	... across the US' economy.
	Mar leading index	0.2%	0.4%	–	Pointing to growth near trend.
	Feb business inventories	0.8%	0.3%	–	Trade volatility seen in inventories too.
	Fedspeak	–	–	–	Bostic at roundtable in Florida.
Fri 19					
Aus	Good Friday public holiday	–	–	–	Markets closed in Aus, NZ, US and more.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	2.8	1.8	2.2
CPI inflation % annual	1.7	1.5	1.9	1.8	1.8	1.6
Unemployment %	5.8	5.7	5.5	5.0	5.5	5.7
Current Account % GDP	-4.7	-3.1	-2.6	-2.1	-0.9	-2.2
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.4	2.1
Consumer Prices %yr	0.1	1.4	2.1	2.4	1.8	1.9
Unemployment Rate %	5.3	4.9	4.4	3.9	3.5	3.5
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	1.2	0.6	1.9	0.8	0.8	0.7
Euro zone						
Real GDP %yr	2.1	2.0	2.4	1.8	1.2	1.4
United Kingdom						
Real GDP %yr	2.3	1.8	1.8	1.4	1.2	1.4
China						
Real GDP %yr	6.9	6.7	6.8	6.6	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	4.0	4.5	4.4	4.2	4.3
World						
Real GDP %yr	3.4	3.4	3.8	3.6	3.5	3.5
Forecasts finalised 10 April 2019						

Interest Rate Forecasts	Latest	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Australia								
Cash	1.50	1.50	1.25	1.00	1.00	1.00	1.00	1.00
90 Day BBSW	1.70	1.80	1.55	1.40	1.40	1.40	1.40	1.40
10 Year Bond	1.88	1.85	1.75	1.80	1.80	1.80	1.85	1.90
International								
Fed Funds	2.375	2.375	2.375	2.375	2.375	2.375	2.375	2.375
US 10 Year Bond	2.50	2.60	2.65	2.70	2.65	2.60	2.55	2.55
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.40	−0.30	−0.20	−0.10

Exchange Rate Forecasts	Latest	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/USD	0.7131	0.70	0.68	0.68	0.69	0.69	0.70	0.70
USD/JPY	111.75	112	113	113	112	111	110	110
EUR/USD	1.1290	1.11	1.10	1.10	1.11	1.12	1.14	1.15
GBP/USD	1.3075	1.31	1.32	1.33	1.33	1.33	1.34	1.34
AUD/NZD	1.0588	1.06	1.05	1.03	1.05	1.06	1.08	1.08

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(ii) physical separation of various Business/Support Units;

(iii) and well defined wall/cell crossing procedures;

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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